

Client Alert

Coronavirus Outbreak: Implications for commercial and finance contracts

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Key Contacts

Matthew Hagopian, Partner
+44 20.7615.3271
mhagopian@milbank.com

Tom Canning, Partner
+44 20.7615.3047
tcanning@milbank.com

Munib Hussain, Senior Associate
+44 20.7615.3013
mhussain@milbank.com

The coronavirus outbreak (officially known as 'COVID-19') that was first reported in Wuhan, China, on 31 December 2019, has been declared by the World Health Organisation as a Public Health Emergency of International Concern. The human cost of the outbreak has been significant and tragically continues.

A number of industries have also been adversely impacted by consequential manufacturing shutdowns, quarantines and export restrictions. In the oil and gas sector, China's LNG demand has been forecast by the Independent Commodity Intelligence Service (ICIS) to fall by 2.9mtpa in 2020 due to the outbreak, putting strain on LNG import contracts. This has already seen some Chinese buyers of LNG seeking relief under LNG supply contracts by serving *force majeure* notices on sellers. A notable reduction in oil demand is also predicted. The mining sector is facing employee shortages due to a reliance on Chinese personnel who are restricted from travelling (which extends beyond China itself), which is having a knock-on impact on production in emerging markets. In shipping, port checks and other restrictions are causing substantial costs and delays.

More broadly, commodity prices are already experiencing widespread reductions due to the fall in demand from China, arguably the most important consumer of raw materials for industrial purposes. Meanwhile, the shutdown, or near-shutdown, of hundreds of factories is already having a significant effect on global supply chains, particularly in the technology and motor industries.

In this alert, we consider two key issues:

1. **Force majeure under commercial contracts**: Assessing whether the outbreak, and the consequential action by governments to contain the outbreak, could constitute *force majeure* events under a commercial contract and, if so, what contractual relief could be available; and
2. **Covenants and Events of Default triggered in finance documents**: Considering whether the outbreak or its effects could trigger a notification obligation, a covenant breach or an event of default pursuant to a finance document.

The analysis below focuses on the position under English law, but similar considerations apply in other common law jurisdictions, including under New York law.

Force Majeure Under Commercial Contracts

1. What is *force majeure*?

The concept of *force majeure* (meaning ‘superior force’ in French) seeks to protect parties to a contract from being held to performance obligations which, due to events outside of their own control and expectation, they cannot fulfil. This civil law derived term has no universally applicable meaning under English law, rather, it is to be assessed on a contract by contract basis, applying normal principles of contractual interpretation / construction.¹

2. *Force majeure* clause

(a) *Force majeure* events

A customary *force majeure* clause in a contract will provide contractual relief to a party affected by an event or circumstance which:

- (i) is beyond the reasonable control of the affected party;
- (ii) is not the result of any act, omission or delay of the affected party;
- (iii) could not have been reasonably foreseen, avoided, or reduced by the exercise of reasonable measures; and
- (iv) causes or results in that party not being able to perform its obligations (other than the obligation to pay money) under the contract.

The contract will also typically have a non-exhaustive list of events or circumstances that would constitute a *force majeure* event (provided that the above general conditions are satisfied) such as acts of nature (sometimes referred to as acts of God, such as earthquakes, tsunami and epidemics), acts of man (such as war, industrial action, piracy, riot and sabotage) and governmental action (such as change in law, regulations and expropriation).

Although this list of events or circumstances is neither exhaustive nor conclusive, it should be noted that the principle of *ejusdem generis* often operates to narrow construction of such a clause when a party is trying to argue that an additional, unlisted event falls within the definition.²

Even if the *force majeure* conditions referred to above are satisfied, a *force majeure* clause may expressly provide that certain events would not constitute *force majeure* events. For example, in LNG sale and purchase agreements, some or all of the following events may expressly be excluded/carved out:

- (i) an inability to pay amounts when due;
- (ii) breakdown of machinery due to a lack of maintenance or normal wear and tear;
- (iii) a loss of market;
- (iv) financial hardship;
- (v) economic downturn; and/or
- (vi) compliance with laws that only or primarily apply to the affected party and not other parties doing business in that country.

Applying the above principles to the outbreak, an affected party would have to show that conditions referred to above are satisfied and that none of the exclusions apply. To make its claim, the affected party would need to establish that the outbreak is contemplated as a *force majeure* event as an “epidemic” or an “act of God” or, if relevant, that the restrictions placed upon companies and citizens by a government in order to help contain the outbreak, are contemplated by the *force majeure* definition as “governmental action”.

Some issues that may be encountered are:

- (i) whether the outbreak could have been reasonably foreseen given the precedents for other major epidemics impacting global supplies, including the unrelated SARS outbreak in 2003;

¹ In many civil law countries, relief is afforded by statute if the ability of the affected party to perform the contract is prevented or impaired by virtue of specified events beyond its control.

² In the *force majeure* context, *ejusdem generis* means that the type of events listed in such a clause will be used as indicators to the court of what else may be impliedly included by a phrase such as “and any other event outside of the Supplier’s control”. If the event is not of the same category or related to those listed, it may be difficult to argue that it is a *force majeure* event per the contract, as was found in *Tandrin Aviation Holdings Ltd v Aero Toy Store LLC* [2010] EWHC 40.

- (ii) where the affected party may not have been directly impacted by the outbreak but rather impacted by the subsequent governmental action to contain the outbreak. In this case, the affected party would have to show that governmental action (for which the contractual relief may differ relative to an act of God *force majeure*) constitutes a *force majeure* event; and
- (iii) where the affected party is not directly affected by the outbreak but yet is unable to perform an obligation under its contract (the affected contract) because its supplier is claiming *force majeure* due to the outbreak. In this case, the affected party will need to show that the supplier's claim for *force majeure* meets the standards under the affected contract, and that the affected contract expressly allows a *force majeure* claim when the affected party's performance is impacted by a *force majeure* event somewhere else along the supply chain. This is often referred to as 'chain *force majeure*'.

It is worth noting in this regard that the English courts have held that a failure of performance due to the provision of insufficient financial resources, or loss of market due to the event, is unlikely to amount to *force majeure*.³ Accordingly, a change in economic / market circumstances due to the outbreak affecting the profitability of a contract or the ease with which the parties' obligations can be performed, is perhaps unlikely to be regarded as being a *force majeure* event.

(b) Contractual Relief

The contractual relief granted under the contract upon the affected party being able to establish a *force majeure* event will be defined in the contract. Typically, subject to providing notice of the *force majeure* event to the counterparty as prescribed by the contract (often described as an "FM Notice"), such relief involves the suspension of obligations, an extension of the period of time in which to perform obligations, an exclusion from certain liabilities for non-performance or delay, or, for prolonged *force majeure* events, termination of the contract.

The type of relief granted under the contract will depend on which performance obligations are being prevented, and why. If the outbreak is causing a temporary period of disruption whilst the party adapts, relief may be a short suspensory period. In contrast, long-term prevention of performance may be met by termination of the contract.

It should also be noted that the solutions, remedies and cures associated with the event often differ depending on the categorisation of that event. For example, the consequences under a contract in relation to governmental action/political *force majeure* can differ significantly from those arising from an "act of God" *force majeure*.

(c) Duty to mitigate

A duty to mitigate the effects of a *force majeure* event is customarily expressly included in a *force majeure* clause. This clause may require the taking of steps that a reasonable and prudent operator may require an affected party to take in order to (i) overcome the relevant *force majeure* event and in order to resume full performance of its obligation, and (ii) minimise the effects of such *force majeure* event.

The English courts have emphasised that reasonable endeavours/mitigation obligations impose a significant burden on a party seeking to rely upon a *force majeure* clause. In particular, the relying party must take into consideration not only its own commercial interests but also those of the other party when deciding what steps it can and should take to avoid or mitigate the effects of a *force majeure* event.⁴

³ *Tandrin Aviation Holdings Ltd v Aero Toy Store LLC* [2010] EWHC 40.

⁴ *Tullow Ghana Limited v Seadrill Ghana Operations Limited* [2018] EWHC 1640 (Comm).

Covenants and Event of Defaults Triggered Under Finance Documents

The coronavirus outbreak may have an impact on a variety of obligations contained in typical finance documents, and it is important for borrowers and lenders to be aware of these.

- (i) **Financial covenants:** if a party faces financial problems due to the outbreak and its consequences, financial covenants and payment obligations may be breached, and such issues should be identified as soon as possible in order for a mitigation strategy to be developed.
- (ii) **Information covenants:** certain information covenants (for example, a covenant to notify the lenders of a *force majeure* event that could reasonably be expected to have a material adverse effect on the borrower's business) may be triggered by the outbreak and/or its consequences, and these obligations are often subject to certain time limits.
- (iii) **Events of default:** unless there is a carve-out for *force majeure*, a suspension or abandonment of a project as a consequence of the outbreak may constitute an event of default under the finance documents.
- (iv) **Material Adverse Change:** it is possible that the outbreak and its consequences result in a "Material Adverse Change" (where the borrower's financial and/or business condition or ability to comply with its contractual obligations under key transaction documents could be materially adversely affected) for the purposes of representations and warranties or any associated event of default under the finance documents.

Risk Management Measures

In order to assess and manage the adverse impact the outbreak may have, it may be prudent to undertake the following risk management steps:

- (i) **Contract Review:** conduct a full review of any impacted commercial contracts or finance documents. Consider in particular the possible application of, and time limits for, claiming *force majeure* or for reporting possible material adverse effects;
- (ii) **Insurance coverage:** Check insurance policies in relation to, for example, impact upon travel insurance for employees, or for business interruption arising from the inability to transport goods;
- (iii) **Risk assessment:** Conduct a risk assessment to assess how and where the outbreak might impact your business most, and what steps can and should be taken to mitigate those risks;
- (iv) **Supply chain review:** Review other businesses in your supply chain to identify any issues they may be facing relating to the outbreak which could mean that a *force majeure* is claimed by them, which in turn affects your ability to perform. It is common for a *force majeure* event to have a 'domino' effect in the oil and gas sector due to the integrated nature of the supply chain;
- (v) **Employee policies:** Deploy an employee travel policy perhaps restricting travel to certain areas, and/or the return of employees to work who have been to affected areas; and
- (vi) **Information and updates:** Provide education and information updates on the outbreak to employees and/or suppliers to help prevent infection and assuage concerns.

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London | 10 Gresham Street, London EC2V 7JD

Nick Angel	nangel@milbank.com	+44-20-7615-3008
Miko Bradford	mbradford@milbank.com	+44-20-7615-3276
James Cameron	jcameron@milbank.com	+44-20-7615-3031
Tom Canning	tcanning@milbank.com	+44-20-7615-3047
William Charles	wcharles@milbank.com	+44-20-7615-3076
John Dewar	jdewar@milbank.com	+44-20-7615-3004
Charles Evans	cevans@milbank.com	+44-20-7615-3090
Apostolos Gkoutzinis	agkoutzinis@milbank.com	+44-20-7615-3074
John Goldfinch	jgoldfinch@milbank.com	+44-20-7615-3109
Alexandra Grant	acgrant@milbank.com	+44-20-7615-3011
Matthew Hagopian	mhagopian@milbank.com	+44-20-7615-3271
Stuart Harray	aharray@milbank.com	+44-20-7615-3083
Joel Harrison	jharrison@milbank.com	+44-20-7615-3051
Manzer Ijaz	mijaz@milbank.com	+44-20-7615-3258
Jacqueline Ingram	jingram@milbank.com	+44-20-7615-3251
Laurence Jacobs	ljacobs@milbank.com	+44-20-7615-3096
Russell Jacobs	rjacobs@milbank.com	+44-20-7615-3009
Rebecca Marques	rmarques@milbank.com	+44-20-7615-3099
Karen McMaster	kcmaster@milbank.com	+44-20-7615-3266
Suhrud Mehta – <i>Co-Managing Partner</i>	smehta@milbank.com	+44-20-7615-3046
Sarbajeet Nag	snag@milbank.com	+44-20-7615-3279
Yushan Ng	yng@milbank.com	+44-20-7615-3341
Lisa O'Neill	loneill@milbank.com	+44-20-7615-3300

Tim Peterson	tpeterson@milbank.com	+44-20-7615-3106
Clive Ransome	cransome@milbank.com	+44-20-7615-3144
Sinjini Saha	ssaha@milbank.com	+44-20-7615-3814
Julian Stait – <i>Co-Managing Partner</i>	jstait@milbank.com	+44-20-7615-3005
Mark Stamp	mstamp@milbank.com	+44-20-7615-3137
Nick Swinburne	nswinburne@milbank.com	+44-20-7615-3278
Mona Vaswani	mvaswani@milbank.com	+44-20-7615-3002
James Warbey	jwarbey@milbank.com	+44-20-7615-3064

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